[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX PENALTIES

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

ON MARCH 31, 1988

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on the subject of tax penalties on March 31, 1988. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of the major penalties currently in the Internal Revenue Code, a discussion of some significant issues relating to the current penalty structure, and a listing of the penalties contained in the Code.

The Subcommittee on Oversight is planning a series of hearings during the second session of the 100th Congress to examine comprehensively the structure, fairness, effectiveness, and application of the civil penalty provisions of the Code. The Subcommittee has announced that its first hearing will address the following overview issues:

(1) What is, or should be, the purpose of the tax penalty system? What is the penalty structure designed to accomplish? What factors or framework of issues should the Subcommittee consider in evaluating the current penalty structure? What are the projections for the future if the current system remains the same?

(2) How might the current penalty structure be reformed? Are existing civil penalties fair and equitable? Are the current penalties consistent, necessary, and understandable? Are existing penalties realistic in relation to the offenses to which they relate? Are they effective deterrents to noncompliance? What are the effects of the current level of penalties on taxpayer morale and compliance?

(3) How is the IRS administering the current penalty provisions? Which penalties are frequently assessed and abated? What internal procedural changes has the IRS adopted to improve the administration of the penalty provisions? What efforts can be taken to make the penalty provisions more understandable to the taxpayer?

The first part of the pamphlet describes the major tax penalties under present law. The second part discusses background and significant issues concerning tax penalties in the Code. The Appendix presents a list of current tax penalties in the Code.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Penalties* (JCS-9-88), March 24, 1988.

I. DESCRIPTION OF SIGNIFICANT PENALTIES

A. Overview

Tax penalties are generally designed to preserve the integrity of the tax system, and have been a component of the tax laws since the Revenue Act of 1913. Although the Internal Revenue Code includes a large number of penalties, only a relatively small number of these penalties are of general applicability. This portion of the pamphlet describes the more significant penalties of general applicability. The Appendix contains a listing of the tax penalties (including the penalty excise taxes) in the Code.

B. Negligence Penalty [2]

Under present law, a taxpayer is subject to a penalty if any part of an underpayment of tax is due to negligence or disregard of rules and regulations. The amount of this penalty is the sum of two components. The first component is an amount equal to 5 percent of the total amount of the underpayment of tax by the taxpayer (whether or not the entire underpayment is the result of the taxpayer's negligence). The second component is an amount equal to 50 percent of the interest payable on the portion of the underpayment attributable to negligence.[3]

For purposes of this penalty, negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code, as well as any careless, reckless, or intentional disregard of rules and regulations.

A special negligence penalty may be imposed with respect to information reporting. If an amount is shown on an information return and the payee or other person with respect to whom the return is made fails properly to show such amount on his or her income tax return, then the portion of any underpayment attributable to such failure is treated as subject to the negligence penalty absent clear and convincing evidence to the contrary.

In some instances, a taxpayer's return might lead to the imposition of both a fraud penalty and a negligence penalty. If an underpayment of a tax is partially attributable to negligence and partially attributable to fraud, the negligence penalty (which generally applies to the entire underpayment of the tax) does not apply to

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[2] Section 6653(a). This penalty was originally enacted as part of the Revenue Act of 1918; the rate as originally enacted was 5 percent of the total amount of the deficiency. The Economic Recovery Tax Act of 1981 added the second, interest-based component of the penalty. The Tax Reform Act of 1986 redrafted the definition of negligence. The Senate-passed version of that Act also would have increased the rate of the penalty to 10 percent but applied the penalty only to the portion of the underpayment attributable to negligence. This change was not adopted in conference.

[3] A technical correction has been considered that would repeal the second component, and, in its place, impose interest on the penalty from the last date prescribed for filing the return to which the penalty relates.

the portion of the underpayment with respect to which a fraud penalty is imposed.

C. Civil Fraud Penalty [4]

Tax fraud can render an individual liable for either civil or criminal sanctions, or both. An individual's actions that provide grounds for a civil tax penalty may also constitute grounds for criminal prosecution for willful attempt to evade or defeat tax.[5]

The Code provides that if any portion of an underpayment of tax is due to fraud, a civil penalty may be imposed equal to (1) 75 percent of the portion of the underpayment attributable to fraud, plus (2) an amount equal to 50 percent of the interest payable on the portion of the underpayment attributable to fraud.[6] Prior to the Tax Reform Act of 1986, the fraud penalty was 50 percent of the entire amount of the underpayment, if any portion of the underpayment was attributable to fraud. Thus, the 1986 Act reduced the scope of items to which the fraud penalty applied but increased the rate of the penalty.

Once the IRS establishes that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. Unlike most other civil penalties, the burden of proof is on the Government to establish that a portion of the underpayment is attributable to civil fraud. Once that burden has been met, the burden shifts to the taxpayer (who is presumed to have the best access to the information) to establish the portion of the underpayment that is not attributable to fraud.

D. Substantial Understatement Penalty [7]

If a taxpayer's correct income tax liability for any taxable year exceeds that reported by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a "substantial understatement" exists and a penalty may be imposed equal to 25 percent of the underpayment of tax attributable to the understatement.

In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) in non-tax shelter

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[4] Section 6653(b). A fraud penalty of 100 percent was enacted in the Revenue Act of 1913. The Revenue Act of 1918 provided that the fraud penalty was 50 percent of the amount of the deficiency. The Tax Equity and Fiscal Responsibility Act of 1982 added the second, interest-based component of the penalty.

[5] Significant criminal penalties, including the criminal tax evasion penalty, are discussed below.

[6] A technical correction has been considered that would repeal this second component, and, in its place, impose interest on the penalty from the last date prescribed for filing the return to which the penalty relates.

[7] Section 6661. This penalty was added to the Code in the Tax Equity and Fiscal Responsibility Act of 1982. The rate of the penalty as enacted in 1982 was 10 percent. The Tax Reform Act of 1986 raised the rate of the penalty to 20 percent, and the Omnibus Budget Reconciliation Act of 1986 raised the rate of the penalty to 25 percent.

cases, facts relevant to the tax treatment of the item were adequately disclosed on the return (or a statement attached thereto).[8]

Whether the taxpayer's filing position is or was supported by substantial authority depends on the circumstances of the particular case. In order to determine whether the weight of authorities that support the taxpayer's position is substantial when compared with those supporting other positions, it is necessary to weigh statutory provisions, court opinions, Treasury regulations and official administrative pronouncements (such as published revenue rulings and revenue procedures) that involve the same or similar circumstances and are otherwise pertinent (giving each its proper weight), as well as the Congressional intent reflected in committee reports. The "substantial authority" standard is less stringent than a "more likely than not" (i.e., more than 50 percent) standard but more stringent than a "reasonable basis" (i.e., non-negligent) standard.

The IRS has discretion to waive all or part of the substantial understatement penalty if the taxpayer establishes that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith. A waiver could be appropriate, for example, if the taxpayer made a good faith mistake in deciding the proper timing of a deduction.

In determining the amount of the penalty to be imposed for a substantial understatement, no account is to be taken of any portion of the substantial understatement attributable to items on which the overvaluation penalty (*see next item*) is imposed.

E. Valuation Penalties [9]

If an individual, personal service corporation, or certain closely held corporations underpays income tax for any taxable year by $1,000 or more as a result of a "valuation overstatement," then a penalty may be imposed. A parallel penalty applies to valuation understatements for purposes of the estate and gift tax.

A "valuation overstatement" exists when the valuation or adjusted basis of any property claimed on the return is 150 percent or more of the correct value or adjusted basis. Thus, the penalty could be imposed as a result of claimed depreciation based on an inflated adjusted basis in property or claimed charitable contributions of allegedly appreciated property. If the valuation claimed is 150 percent or more but not more than 200 percent of the correct valuation, then a penalty may be imposed equal to 10 percent of the underpayment of tax attributable to the overvaluation. If the valuation claimed is more than 200 percent but not more than 250 percent of the correct valuation, then a penalty may be imposed equal

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[8] A special rule governs items "attributable to a tax shelter," meaning a partnership or other entity, plan or arrangement, the principal purpose of which is the avoidance or evasion of Federal income tax. In the case of such a tax shelter item, adequate disclosure on the return will not, by itself, reduce the amount of the understatement. Instead, the amount of the understatement is reduced by the portion attributable to a tax shelter item only if (1) the treatment of the item is or was supported by substantial authority, *and* (2) the taxpayer reasonably believed (based upon the taxpayer's analysis, or that of a professional tax advisor, of pertinent authorities) that the tax treatment claimed was more likely than not the proper treatment.

[9] Sections 6659 and 6660. The valuation overstatement penalty (sec. 6659) was added by the Economic Recovery Tax Act of 1981. The valuation understatement penalty (sec. 6660) was added by the Deficit Reduction Act of 1984.

to 20 percent of the underpayment of tax attributable to the overvaluation. If the valuation claimed is more than 250 percent of the correct valuation, then a penalty may be imposed equal to 30 percent of the underpayment of tax attributable to the overvaluation.[10]

Both the valuation overstatement penalty and the negligence (or fraud) penalty may be applied with respect to the same underpayment. The IRS may waive all or part of the valuation overstatement penalty on a showing by the taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that the claim was made in good faith.

F. Penalties for Failure to File and Failure to Pay

Failure to file[11].—A taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to 5 percent of the net amount of tax due for each month the return is not filed, up to a maximum of 5 months or 25 percent. The net amount of tax due is the excess of the amount of tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of the tax. The amount of any applicable credit that may be claimed on the return also may be used to reduce the net amount of tax due.

In the case of a failure to file an income tax return within 60 days of the due date, the failure to file penalty may not be less than the lesser of $100 or 100 percent of the amount required to be shown on the return. In addition, if a penalty for failure to file and a penalty for failure to pay tax shown on a return apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return.

Failure to pay tax shown on return[12].—A taxpayer who fails to pay the amount of tax shown on a return is subject to a penalty of 0.5 percent of the amount of tax shown on the return for each month the amount remains unpaid, up to a maximum of 25 percent (50 months). For purposes of calculating the amount of the penalty for any month, the amount of unpaid tax liability is reduced by the amount of tax paid on or before the beginning of that month and by the amount of any credit that may be claimed on the return.[13]

Failure to pay tax after notice and demand [14].—A taxpayer who fails to pay an amount of tax required to be shown on a return that

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[10] For purposes of the estate and gift tax, if the valuation claimed for property is 50 percent or more but not more than 66-2/3 percent of the correct valuation, then a penalty may be imposed equal to 10 percent of the underpayment of tax attributable to the valuation understatement. If the valuation claimed is 40 percent or more but less than 50 percent of the correct valuation, then a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the valuation understatement. If the valuation claimed is less than 40 percent of the correct valuation, then a penalty may be imposed equal to 30 percent of the underpayment of tax attributable to the valuation understatement.

[11] Section 6651(a)(1). A 25-percent penalty for failure to file a tax return was enacted in 1926. The present penalty structure of 5 percent per month, up to a total of 25 percent, was enacted in 1935.

[12] Section 6651(a)(2). This penalty was added by the Tax Reform Act of 1969.

[13] If the amount required to be shown as tax on a return is less than the amount actually shown as tax on the return, the penalty is based on the amount required to be shown as tax on the return.

[14] Section 6651(a)(3). This penalty was added by the Tax Reform Act of 1969.

is not so shown within 10 days of notice and demand for such tax is subject to a penalty equal to 0.5 percent of the amount of tax stated in the notice and demand for each month the amount remains unpaid, up to a maximum of 25 percent (50 months). The rate of this penalty increases to one percent for each month the amount is outstanding after the IRS notifies the taxpayer that the IRS is going to levy upon the assets of the taxpayer.[15]

The IRS has discretion to waive the imposition of any failure to file or failure to pay penalty if the taxpayer's failure was due to reasonable cause and not willful neglect.

G. Information Reporting Penalties[16]

Under present law, the Code requires that information returns be filed with the IRS, and a copy be provided to the taxpayer, detailing all wages, most other types of income, and some deductions. These requirements apply to a variety of specific payments, and are described in a number of Code provisions.

The Code also provides civil penalties for each failure either to file an information return with the IRS or to provide a copy to the taxpayer. The general penalty for failure to supply an information return to the IRS is separate from the penalty for failure to provide a copy to the taxpayer. Generally, these penalties are $50 for each failure, with a maximum penalty of $100,000 per calendar year applicable to failures to file information returns with the IRS, and another maximum penalty of $100,000 per calendar year applicable to failures to provide copies of information returns to payees.[17]

If the failure to file information returns with the IRS is due to intentional disregard of the filing requirement, these penalties are imposed without an overall maximum. In addition, the amount of the penalty per return not filed is increased from $50 to $100 (or a higher amount for some types of information returns).[18]

The Code also provides a penalty [19] of either $5 or $50 (depending on the nature of the failure) for each failure to furnish a correct taxpayer identification number (for individuals, the social security number). These taxpayer identification numbers are the principal means by which the IRS matches the information reported by the third party with the taxpayer's tax return.

The Code also includes a penalty for failure to include correct information either on an information return filed with the IRS or on the copy of that information return supplied to the payee. This

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[15] Section 6651(d). This was added by the Tax Reform Act of 1986 in place of a user fee proposed by the Administration. *See* footnote 53, below.

[16] Sections 6721-6724. These penalties were first enacted in the Internal Revenue Code of 1954. The penalty was $1 for each statement not filed, up to a maximum of $1,000. The Revenue Act of 1962 increased the penalty to $10 for each statement not filed, up to a maximum of $25,000. The Tax Equity and Fiscal Responsibility Act of 1982 increased the penalty to $50 for each statement not filed, up to a maximum of $50,000. The Tax Reform Act of 1986 increased the maximum to $100,000 and consolidated and rewrote these penalties. As information reporting requirements were added to the Code, these penalties were expanded to reflect the additional information reporting requirements.

[17] These caps do not apply to failures with respect to interest or dividend returns (section 6724(c)(2)).

[18] For example, the penalty for failure to report cash transactions that exceed $10,000 is 10 percent of the amount that should have been reported.

[19] Section 6676.

penalty applies to both an omission of information or an inclusion of incorrect information. The amount of the penalty is $5 for each information return or payee statement, up to a maximum of $20,000 in any calendar year. This maximum does not apply in cases of intentional disregard of the requirement to file accurate information returns. In addition, the amount of the penalty per inaccurate return is increased in cases of intentional disregard.

The penalty for the failure to include correct information does not apply to an information return if a penalty for failure to supply a correct taxpayer identification number has been imposed with respect to that information return.

In general, no penalty is imposed if the failure to file an information return with the IRS, to provide a copy to the payee, or to include correct information on either of those returns is due to reasonable cause and not to willful neglect.[20] Thus, under this standard, if a person required to file fails to do so because of negligence or without reasonable cause, that person would be subject to these penalties.

H. Estimated Tax Penalties

Individual [21].—Individuals must generally make quarterly estimated tax payments that equal at least 25 percent of the lesser of (1) 100 percent of the prior year's tax liability or (2) 90 percent (80 percent for taxable years beginning before January 1, 1988) of the current year's tax liability. For this purpose, amounts withheld from wages are considered to be estimated tax payments.

If an individual fails to make the required estimated tax payments under these rules, a penalty is imposed. The amount of the penalty is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment. The amount of the underpayment is the excess of the required payment over the amount (if any) of the installment paid on or before the due date for the installment. The period of the underpayment runs from the due date of the installment to the earlier of (1) the 15th day of the fourth month following the close of the taxable year, or (2) the date on which each portion of any underpayment is made. No penalty is imposed if the amount of tax shown on the return (net of wage withholding) for any taxable year is less than $500.

Corporate[22].—Under present law, a corporation that fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty, which may not be waived. The amount of the penalty is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment.

For taxable years beginning after December 31, 1987, the underpayment penalty with respect to any installment applies to the difference between payments made by the due date of the installment

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[20] Higher standards apply with respect to interest or dividends returns (section 6724(c)).

[21] Section 6654. The requirement that individuals make estimated tax payments was added by the Current Tax Payment Act of 1943.

[22] Section 6655. The requirement that corporations make estimated tax payments was added by the Internal Revenue Code of 1954.

and the lesser of an installment based on (1) 90 percent of the tax shown on the return,[23] or (2) 100 percent of the tax shown on the preceding year's return. Exception (2) generally is not available to a large corporation, except that a large corporation can use that exception for purposes of making its first estimated payment for any taxable year. Thus, both large and small corporations may base their first estimated tax payment for any taxable year on 100 percent of the tax shown on the preceding year's return. A large corporation is defined as a corporation having at least $1 million of taxable income in any of the three prior taxable years. No penalty is imposed if the tax shown on the return for any taxable year is less than $500.

I. Tax Shelter Penalties

Promoting abusive tax shelters[24].—The Code imposes a penalty upon those who promote abusive tax shelters. The penalty applies to persons who organize, assist in the organization of, or participate in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if, in connection with such organization or sale, the person makes or furnishes either (1) a statement which the person knows or has reason to know is false or fraudulent as to any material matter with respect to the availability of any tax benefit alleged to be allowable by reason of holding an interest in the entity or participating in the plan or arrangement, or (2) a "gross valuation overstatement" (i.e., a representation of the value of services or property which exceeds 200 percent of the correct value and which is directly related to the amount of any income tax deduction or credit allowable to any participant) as to a matter material to the entity, plan or arrangement, whether or not the accuracy of the statement of valuation is disclaimed. Reliance by the purchasing taxpayer or actual underreporting of tax need not be shown.

The amount of the penalty equals the greater of $1,000 or 20 percent of the gross income derived or to be derived by that promoter or organizer from such activity. This penalty is in addition to all other penalties provided for by law.

The IRS may waive all or any part of the penalty in the case of a gross valuation overstatement upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

Aiding and abetting the understatement of tax liability[25].—The Code imposes a penalty on any person who aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document under the internal revenue laws which the person knows will be used in connection with any material matter arising under the tax laws, and which the

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[23] Corporations may compute these installments as if the income already received during the year was placed on an annual basis if doing so reduces the amount otherwise required to be paid.

[24] Section 6700. This penalty was added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982. The rate of the penalty was 10 percent as originally enacted. The rate of the penalty was increased to 20 percent in the Deficit Reduction Act of 1984.

[25] Section 6701. This penalty was added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982.

person knows will (if used) result in an understatement of the tax liability of another person. This penalty, which is $1,000 for each return or other document ($10,000 in the case of returns and documents relating to the tax of a corporation), can be imposed whether or not the taxpayer knows of the understatement. The penalty can, however, be imposed only once for any taxable period (or taxable event) with respect to documents relating to any one person.

The aiding and abetting penalty applies only if the person is directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document that will be used under the tax laws, or directly "procures" a subordinate to do any act subject to this provision. The requirement that a person "know" [26] that a document will be used in connection with a material matter arising under the tax laws and the requirement that the person "know" that the document, if used, will result in an understatement of tax, were designed to limit the penalty to cases involving willful attempts to accomplish an understatement of the tax liability of a third party. Thus, for example, a tax advisor would not be subject to this penalty for suggesting an aggressive but supportable filing position to a client even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. If, however, the tax advisor suggested a position he or she knew could not be supported on any reasonable basis under the law, the penalty could apply.

The Government bears the burden of proof with respect to this penalty. Furthermore, this penalty generally is in addition to all other penalties provided by law except the penalty on income tax return preparers (discussed below). If either the return preparer penalty or the aiding and abetting penalty may apply with respect to any document, the IRS must choose which penalty to impose.

Failure to furnish information regarding tax shelters[27].—The person having principal responsibility for organizing a tax shelter must register that tax shelter with the IRS.[28]

The Code also provides a penalty for failure to register a tax shelter with the IRS or for filing false or incomplete information with respect to such registration. The penalty for failure to register is the greater of 1 percent of the aggregate amount invested in such tax shelter or $500. No penalty is imposed if the failure is due to reasonable cause.

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[26] This generally requires actual knowledge. This is a subjective test, which may result in difficulties in applying this penalty. It has been suggested that some of this difficulty could be reduced if the standard were objective. Thus, a person would be subject to penalty if the person reasonably should have known both that the return or other document would be used in connection with any material matter and that it would result in an understatement of tax liability.

[27] Section 6707. This penalty was added to the Code by the Deficit Reduction Act of 1984. The Tax Reform Act of 1986 eliminated the cap on the penalty for failure to register a tax shelter and increased the amount of the penalty from $50 to $250 for failure to include the tax shelter identification number on the taxpayer's return.

[28] If the person principally responsible for organizing the tax shelter fails to register the shelter as required, then any person who participates in the organization of the shelter must register the shelter. A person who is secondarily liable for registering the shelter must register it not later than the day on which the first offering for sale of any interest in the shelter is made. In the event that persons who are principally and secondarily liable for registering a shelter fail to register the shelter, any person participating in the management or sale of the investment must register the shelter. Registration by the manager or seller does not relieve the organizer or promoter of liability for the penalties for failure to register.

The Code also provides that persons (such as promoters) who are required to furnish to investors an identification number and who fail to do so are subject to a penalty of $100 for each such failure. Moreover, any investor who fails to include the number on his or her tax return is subject to a penalty of $250, unless the failure is due to reasonable cause.

Failure to maintain lists of investors in potentially abusive tax shelters[29].—Any person who organizes any potentially abusive tax shelter or who sells any interest in such a shelter must maintain lists of purchasers. A potentially abusive shelter is any tax shelter that is required to be registered with the IRS or that is of a type that has a potential for tax avoidance or evasion and is described in IRS regulations. Failure to maintain the required lists of purchasers subjects the organizer or seller of the tax shelter to a penalty of $50 for each name omitted from a list, up to a maximum of $100,000 in any calendar year. The penalty may not be imposed where the failure is due to reasonable cause and not due to willful neglect.

J. Return Preparer Penalties

Negligent or fraudulent preparation[30].—The Code imposes a penalty of $100 on an income tax return preparer for each return on which an understatement of tax is caused by the return preparer's negligent or intentional disregard of the Federal tax law. If any part of an understatement of tax is due to a return preparer's willful attempt to understate tax, a $500 penalty is imposed upon the return preparer.

For purposes of this penalty, the term "income tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of an income tax return or claim for refund.[31]

Failure to furnish copy to taxpayer or other information [32].—If an income tax return preparer fails to furnish a completed copy of a return or claim for refund to the taxpayer by the time the return or claim for refund is presented for the taxpayer's signature, the return preparer is subject to a penalty of $25 for each such failure, unless the failure was due to reasonable cause and not willful neglect.

A return preparer is also subject to a $25 penalty if the return preparer fails to furnish on a return his or her identifying number (generally his or her social security number). A $50 penalty is imposed for each failure (up to $25,000 for any return period) by a return preparer to retain for three years after the close of the return period a completed copy of the return or a list of the name

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[29] Section 6708. This penalty was added to the Code by the Deficit Reduction Act of 1984. The cap on this penalty was increased from $50,000 to $100,000 per calendar year by the Tax Reform Act of 1986.

[30] Section 6694. This penalty was added to the Code by the Tax Reform Act of 1976.

[31] A person is not an income tax return preparer merely because he or she (1) furnishes typing, reproducing, or other mechanical assistance; (2) prepares a return or claim for refund for his or her employer or for employees of the employer, provided the employment is regular and continuous; (3) prepares a return or claim for refund for any trust or estate of which that person is a fiduciary; or (4) prepares a claim for refund for a taxpayer in response to a notice of deficiency issued to the taxpayer by the IRS or under certain audit procedures.

[32] Section 6695. This penalty was added to the Code by the Tax Reform Act of 1976.

and taxpayer identification number of the taxpayer for whom the return was prepared. These penalties do not apply if the failure was due to reasonable cause and not willful neglect.

In addition, if a return preparer endorses or otherwise negotiates a check issued to the taxpayer with respect to any income tax return which the return preparer has prepared, a $500 penalty is imposed with respect to each such check. This penalty does not apply with respect to the deposit by a bank of the full amount of the check in the taxpayer's account in the bank for the benefit of the taxpayer.

K. Penalties Relating to Pensions, Employee Benefits, and Exempt Organizations

1. Qualified plans

Amounts received by 5-percent owners.[32a]—An additional 10-percent income tax applies to amounts received from a qualified plan by a 5-percent owner to the extent such amounts exceed the benefits provided for such individual under the plan formula.

Tax on early distributions.[32b]—A 10-percent additional income tax is imposed on early distributions from qualified plans, tax-sheltered annuities, or individual retirement arrangements (IRAs). The additional income tax does not apply to (1) certain distributions that are part of a scheduled series of substantially equal periodic payments, (2) distributions made to an employee if the employee separates from service after attainment of age 55 (not applicable to IRAs), (3) distributions made to pay certain medical expenses (not applicable to IRAs), (4) distributions after the death of the employee, (5) distributions after age 59½, and (6) certain distributions from an employee stock ownership plan (ESOP).

Tax on failure to meet minimum funding standards.[32c]—Certain qualified plans are subject to minimum funding standards that are designed to ensure that plan benefits are adequately funded. If an employer fails to make contributions to a plan sufficient to meet the minimum funding requirements, a nondeductible excise tax of 5 percent is imposed on the amount of the accumulated funding deficiency. The tax is increased to 100 percent of the accumulated funding deficiency if the deficiency is not corrected within a certain period. The employer and each member of the employer's controlled group is jointly and severally liable for the tax. For years beginning after 1988, the first level tax is increased from 5 percent to 10 percent of the accumulated funding deficiency.

Tax on nondeductible contributions.[32d]—A nondeductible excise tax of 10 percent is imposed on nondeductible contributions to qualified employer plans. The tax is imposed on the employer making the contributions.

[32a] Section 72(m)(5).

[32b] Section 72(t). A similar tax is imposed on premature distributions from annuity contracts under section 72(q). A similar tax is imposed under section 72(o)(2) on premature distributions from plans to which deductible employee contributions have been made. Technical corrections to the Tax Reform Act of 1986 would repeal section 72(o)(2); the section is no longer necessary because the tax under section 72(t) applies to distributions to which section 72(o)(5) applied.

[32c] Section 4971.

[32d] Section 4972.

Tax on certain accumulations.[32e]—Minimum distributions from a qualified retirement plan or an eligible deferred compensation plan [32f] must begin, in general, no later than the April 1 following the year in which the individual attains 70½. An excise tax equal to 50 percent of the amount by which the minimum amount required to be distributed exceeds the amount actually distributed is imposed on the individual entitled to receive the distribution.

Tax on prohibited transactions.[32g]—The Code includes prohibited transaction rules that are designed to prevent certain uses of plan assets. In general, a prohibited transaction is a direct or indirect (1) sale or exchange or leasing of property between a plan and a disqualified person; (2) lending of money or other extension of credit between a plan and a disqualified person; (3) transfer to, or use by or for the benefit of, a disqualified person of the assets of a plan; (4) dealing by a fiduciary with plan assets for his or her own interest or for his or her own account; (5) receipt of any consideration for the personal account of a fiduciary from any party dealing with the plan in a transaction involving plan assets. A disqualified person includes a fiduciary, a person providing services to the plan, the employer maintaining the plan, and certain other individuals and entities related to the plan.

An initial excise tax is imposed on a prohibited transaction equal to 5 percent of the amount involved in the transaction. The tax is increased to 100 percent of the amount involved if the transaction is not corrected within a certain period. The tax is payable by any disqualified person who participates in the transaction, other than a fiduciary acting as such.

Tax on certain excess contributions.[32h]—The Code imposes nondiscrimination rules on elective deferrals under a cash or deferred arrangement, employee contributions under a qualified plan, and employer matching contributions (i.e., contributions made to a plan on account of an employee contribution or elective deferral). Contributions in excess of those permitted by the nondiscrimination rules are called excess contributions, in the case of elective deferrals, and excess aggregate contributions in the case of employee and matching contributions. A nondeductible excise tax of 10 percent of the amount of excess contributions and excess aggregate contributions is imposed on the employer maintaining the plan to which excess contributions or excess aggregate contributions are made. The tax does not apply if the excess contribution or excess aggregate contribution is distributed (or, if forfeitable, is forfeited) before 2½ months after the end of the plan year in which the contributions arose.

Tax on reversion of qualified plan assets.[32i]—In general, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, the assets held under a qualified plan may not be used for, or diverted to, purposes other than the exclusive benefit of employees. However, if assets in excess of liabilities for benefits remain in a defined benefit pension plan upon plan termination as

[32e] Section 4974.
[32f] Section 457.
[32g] Section 4975.
[32h] Section 4979.
[32i] Section 4980.

a result of actuarial error, then those assets may be paid to the employer as a reversion.

Employer reversions of plan assets are subject to a 10-percent nondeductible excise tax payable by the employer. The excise tax is intended to recover, at least in part, the tax benefit the employer received by reason of the deferral of taxes on the income on the employer's contributions. A reversion is not subject to this excise tax to the extent the reversion is transferred to an employee stock ownership plan (ESOP) and certain requirements are satisfied. The ESOP exception does not apply to amounts transferred pursuant to a plan termination after December 31, 1988.

Tax on excess distributions.[32j]—An excise tax is imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. To the extent that aggregate annual distributions paid to a participant from such tax-favored retirement arrangements are excess distributions, an excise tax equal to 15 percent of the excess is imposed. This excise tax is reduced by the amount of tax imposed on the distribution by the 10 percent additional income tax on early distributions. In general, excess distributions are the amount of retirement distributions made with respect to an individual during any calendar year, to the extent such amount exceeds the greater of (1) $150,000, or (2) $112,500 (indexed). A special higher ceiling applies to lump sum distributions.

Special ESOP provisions.—Employee stock ownership plans (ESOPs) are qualified plans and, thus, unless specifically excepted, are subject to the same requirements and excise tax provisions as other qualified plans. In addition, special tax benefits are provided with respect to ESOPs. Two of these special provisions are (1) the nonrecognition of gain on certain sales of employee securities to an ESOP,[32k] and (2) an estate tax deduction for 50 percent of the proceeds of certain sales to an ESOP.[32l]

Employer securities acquired by an ESOP through one of these transactions are required to be held by the ESOP for a certain period. An excise tax is imposed if the securities are disposed of before expiration of the period.[32m] The tax is payable by the employer maintaining the plan to which the securities were sold.

In addition, employer securities acquired by an ESOP through one of these transactions may not be allocated to the person who sold the securities to the ESOP or certain persons related to the seller. An excise tax equal to 50 percent of the amount of the allocation is imposed on any prohibited allocation.[32n] The tax is payable by the employer maintaining the plan to which the employer securities were sold.

2. Individual retirement arrangements (IRAs)

IRAs are subject to some, but not all, of the provisions that apply to qualified plans. For example, the additional income tax on early

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[32j] Section 4981. Technical corrections to the Tax Reform Act of 1986 would renumber the section 4980A.
[32k] Section 1042.
[32l] Section 2057.
[32m] Sections 4978 and 4978A.
[32n] Section 4979A.

distributions,[32o] the tax on certain accumulations in retirement plans,[32p] and the tax on excess distributions,[32q] apply to IRAs.

In addition, IRAs and certain custodial accounts are subject to an excise tax on excess contributions.[32r] The amount of the tax is 6 percent of the amount of the excess contributions, and is paid by the individual on whose behalf the account is maintained.

3. Employee benefits

Funded welfare benefits plan.[32s]—If an employer-maintained welfare benefit fund provides a disqualified benefit during a taxable year, the employer is liable for a tax equal to 100 percent of such disqualified benefit. For purposes of this provision, a disqualified benefit generally is (1) any post-retirement medical benefit or life insurance benefit provided with respect to a key employee if a separate account is required to be established for such employee under section 419A(d) and such payment is not from such account, (2) any post/retirement medical benefit or life insurance benefit provided with respect to a highly compensated employee unless the plan meets the applicable nondiscrimination rule[32t] with respect to such benefit (whether or not such requirements apply to such plan), and (3) any portion of a welfare benefit fund reverting to the benefit of the employer.

Tax on certain fringe benefits.[32u]—Gross income does not include any employer-provided fringe benefit which qualifies as a (1) no-additional-cost service, (2) qualified employee discount, (3) working condition fringe, or (4) de minimis fringe.[32v] In order to be excludable as a no-additional-cost service or a qualified employee discount, the goods or services provided to the employee must be offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services.

The employer may elect to be covered by a special grandfather rule that relaxes this line of business requirement. If the employer elects the grandfather rule, the employer is subject to an excise tax for any calendar year for which the grandfather rule election is in effect if the fair market value of all excludable no-additional-cost services and qualified employee discounts exceeds a certain amount. The rate of the tax is 30 percent of the excess fringe benefits.

4. Penalties relating to information returns, reports, etc.

Employers, plan administrators, and trustees and custodians of IRAs are required to report certain information to the Internal Revenue Service or plan participants with respect to pension and employee benefit plans and IRAs. Various penalties are imposed with respect to such requirements, depending on the nature of the

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[32o] Section 72(t).
[32p] Section 4974.
[32q] Section 4981. Technical corrections to the Tax Reform Act of 1986 would renumber the section 4980A.
[32r] Section 4973.
[32s] Section 4976.
[32t] Section 505(b).
[32u] Section 4977.
[32v] Section 132.

requirement, the information involved, and to whom the information must be provided.[32w]

5. Exempt organizations

Private foundations.—The Tax Reform Act of 1969 enacted a two-tier system of "penalty" excise taxes intended to ensure compliance with the private foundation rules set forth in sections 4941–4945. For example, violations of the rules relating to self-dealing transactions, required charitable distributions, excess business holdings, jeopardizing investments, or taxable expenditures, generally result in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person); a first-level tax also may apply to foundation managers who knowingly participated in the prohibited act. If the violation is not corrected within a specified period, second-tier excise taxes generally are imposed. The excise taxes may be doubled in the case of flagrant or repeat violations.

Other charities.—An excise tax applies in the case of "excess" lobbying expenditures of public charities that have elected to be subject to certain dollar limitations on their lobbying expenditures, pursuant to a provision enacted in the Tax Reform Act of 1976 (sec. 4911). The Revenue Act of 1987 enacted two-tier excise taxes on prohibited political campaign expenditures by public charities (sec. 4955), and excise taxes on disqualifying lobbying expenditures of certain charitable organizations (sec. 4912).

Black lung benefit trusts.—A two-tier system of penalty excise taxes, similar to the structure of the private foundation excise taxes, applies with respect to self-dealing and taxable expenditures involving black lung benefit trusts (secs. 4951–52). Also, a five-percent excise tax applies to the amount of excess contributions to such trusts (sec. 4953).

L. Criminal Penalties

Tax evasion[33].—The Code provides that any person who willfully attempts to evade or defeat any tax[34] imposed by the internal revenue laws shall be guilty of a felony and, upon conviction, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution. To convict a defendant under this section, the Government must prove[35] beyond a reasonable doubt: (1) an additional tax due and owing; (2) knowledge on the part of the defendant that an additional tax was due; and (3) an affirmative act taken by the defendant to willfully evade, or attempt to evade, the tax. Willfulness in this context means the "voluntary, intentional violation of a known legal duty." [36]

Willful failure to collect or pay over tax[37].—The Code provides that any person required to collect, account for, and pay over to

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[32w] See, e.g., Sections 6652, 6659A, 6690, 6692, 6693, and 6704.

[33] Section 7201.

[34] This includes any income, estate and gift, employment, or excise tax.

[35] The burden of proof is on the Government in all criminal proceedings.

[36] *United States* v. *Pomponio*, 429 U.S. 10, 13 (1976), *reh. denied*, 429 U.S. 987 (1976). This definition of "willful" is generally applicable to all criminal provisions of the Internal Revenue Code. *See United States* v. *Bishop*, 412 U.S. 346 (1973).

[37] Section 7202.

the Government any tax imposed by internal revenue laws (e.g., an employer required to withhold and pay over Federal wage and FICA taxes) who willfully fails to do so shall be guilty of a felony and, upon conviction, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

Willful failure to file return, supply information, or pay tax[38].—The Code provides that any person required to pay any estimated tax or tax, or required to file a return, keep records, or supply information, who willfully fails to do so shall be guilty of a misdemeanor and, upon conviction, shall be fined not more than $25,000 ($100,000 in the case of a corporation), or imprisoned not more than 1 year, or both, together with the costs of prosecution. A conviction under this provision may be based on a failure to act on the part of the defendant (e.g., a taxpayer's willful failure to file a return), whereas a conviction for tax evasion (discussed above) requires the Government to prove an affirmative act taken by the defendant to willfully evade tax (e.g., creating fraudulent documents).

False returns[39].—The Code provides that any person who willfully submits any false return, statement, or other document that contains a declaration that it is made under penalties of perjury, or any person who willfully aids or assists in the preparation or presentation of such a false return or document, shall be guilty of a felony and, upon conviction, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

The Internal Revenue Code contains additional criminal penalties that apply to other offenses.[40] In addition, the United States Code contains a number of criminal provisions of general applicability (e.g., conspiracy, false statement, and mail fraud) that may also apply to tax offenses.[41]

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[38] Section 7203.
[39] Section 7206.
[40] These are listed in the Appendix.
[41] Because of the general nature of these criminal provisions, they are not listed in the Appendix.

II. BACKGROUND AND ANALYSIS

A. Development of Penalty Structure

As the income tax laws have increased in scope and complexity over the past 75 years, so too have income tax penalties grown in number and complexity. In many ways, the growth of penalties is parallel to and results directly from the growth of the income tax laws. This growth also, of course, parallels the growth and increasing complexity of transactions in the underlying economy. Although the early income tax laws contained relatively few penalties as compared with present law, a number of the important issues arising out of the current civil penalty structure have existed for a number of years. This is perhaps best illustrated by developments involving the negligence and fraud penalties.

The negligence and fraud penalties were originally enacted as part of the Revenue Act of 1918 [42] and were part of both the 1939 Code and the 1954 Code. Although these were probably the most important civil penalties in the Code, several aspects of these penalties led to the development of additional penalties.

One important aspect of both of these penalties that has existed from the date of their original enactment is fault: the intent of the taxpayer is vital to determining whether the penalty applies in a particular circumstance. Indeed, an element of fault seems inherent to concepts of negligence or fraud.

The element of fault also created several difficulties. Disputes concerning these penalties revolved around the knowledge or state of mind of the taxpayer; in many instances, resolving these disputes was difficult. In addition, in some instances the taxpayer had taken a seemingly indefensible return position, but was not held subject to either the negligence or fraud penalties because the requisite element of fault could not be established. These difficulties led to the establishment of no-fault penalties, such as the substantial understatement or valuation overstatement penalties.[43] The latter penalties are imposed on the basis of the return position taken by the taxpayer, which can be established by objective evidence, as opposed to the more subjective element of knowledge or state of mind of the taxpayer.

Another aspect of the negligence and fraud penalties that led to the development of additional penalties is the ability of taxpayers generally to avoid the imposition of the negligence or fraud penal-

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[42] Section 250(b) of Public Law No. 254, 65th Congress; February 24, 1919. The fraud penalty predates this Act, but the prior version was substantially different from the 1918 Act provision, which parallels present law.

[43] An element of fault may be relevant with respect to these penalties, in that the IRS has discretion to waive these penalties if the taxpayer establishes that (1) there was a reasonable basis or reasonable cause for the position claimed on the return and (2) the taxpayer acted in good faith.

ties if they reasonably relied on a competent tax advisor. This aspect of these penalties is closely related to the fault element: reasonable reliance on a competent tax advisor may mitigate or eliminate any element of fault on the part of the taxpayer.

The Code also includes penalties on return preparers. These penalties are not, however, coextensive with penalties imposed directly on taxpayers. The standards tend to be applied differently; behavior generally must be more egregious for a penalty to be imposed upon a return preparer. Also, the dollar amount of the penalties on return preparers is significantly lower than the level imposed under the general penalties. Thus, under present law, a return position that could be subject to a substantial penalty if the taxpayer completed his or her own return could escape penalty or be subject to a relatively minimal penalty if the return is completed by a return preparer.

Another factor that led to the development of additional penalties has been the failure by the IRS and the courts to apply the negligence and fraud penalties in some instances where their application would seem fully justified.

In one Tax Court case, for example, the taxpayer had kept detailed mileage records, required by his employer for reimbursement purposes, that indicated that his business use of a vehicle was approximately five percent of total use. On his tax return, the taxpayer claimed 70 percent business use, with no records to justify this claim. The Tax Court properly allowed only five percent business use. A negligence or fraud penalty, however, was not imposed.[44]

In another Tax Court case, the taxpayer had kept detailed records so that he could be reimbursed by his employer, but claimed on his tax return approximately 35,000 miles of business use beyond what his records demonstrated, without any justification. No negligence penalty was imposed. In another case, the taxpayer produced a diary purporting to justify the claimed deductions. The Tax Court called the diary a "fabrication" and said that the taxpayer "was not telling the truth." The Court still permitted him a deduction; the regular negligence or civil fraud penalty was not imposed. Another taxpayer apparently claimed a deduction for business mileage that exceeded the total mileage shown on his odometer, but a negligence or civil fraud penalty was not imposed.

In another Tax Court case, the taxpayer claimed that 89 percent of his main house was used exclusively for business purposes, and that his children were not permitted to use the living room, the dining room (which they called a conference room), or the family room, which contained a wide-screen television, but were restricted to several bedrooms, bathrooms, and one of the kitchens. (The house contained approximately 9,000 square feet and 40 rooms.) The Tax Court stated that the business usage was "substantially overstated" and imposed the negligence penalty. The fraud penalty was not discussed.[45]

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[44] Section 6214 provides that the Tax Court has jurisdiction over penalties only if the IRS requests that they be imposed.

[45] In addition, these taxpayers owned three cars: a sedan, a station wagon, and a two-seat sports car. They claimed 100 percent business use of the sedan and station wagon, and testified

Continued

Other developments in the Code, unrelated to the negligence and fraud penalties, have had an impact on the development of penalties. For example, during the 1980's a number of detailed information reporting requirements have been added to the Code. These information reporting requirements were added to improve compliance and the ability of the IRS to verify compliance with the tax laws. As the information reporting structure became more detailed, so did the parallel penalty structure.

The administration of the tax laws by the executive branch and the courts also has had an impact on the development of penalties. Relatively few prosecutions are undertaken each year for criminal fraud.[46] This increases reliance on the civil fraud penalty. Also, the difficulties experienced by both the IRS and the courts in administering fault-based penalties, such as negligence and fraud, led to the development of no-fault penalties.

Another administrative development that, at least indirectly, has increased the number of, and level of specificity in, penalties has been the increased difficulties experienced by the IRS and Treasury in promulgating guidance on the tax laws. For example, there has been a substantial backlog in issuing regulations during this entire decade. The resulting delay in providing administrative guidance often makes it desirable, when possible, to provide as much guidance as possible in the statute, thereby increasing the detail in penalty provisions (as well as tax provisions generally).

An example that illustrates many of these elements was the growth of abusive tax shelters in the late 1970's and early 1980's. This growth was attributable to a number of factors, such as the willingness of taxpayers to take aggressive return positions, shortcomings in the substantive law, and administrative delay by both the IRS and the courts in resolving shelter disputes. One of the early legislative efforts undertaken to deal with tax shelters was the imposition of penalties on shelter organizers and promoters. Although the imposition of these penalties did not deal with all aspects of the abusive tax shelter problem, it was helpful in both indicating the increasing level of Congressional concern with the problem and providing increased information to the Government on the extent of the problem. Although the importance of these penalties may have been eclipsed by the enactment of the passive loss rules in the Tax Reform Act of 1986, they were an important element in dealing with abusive tax shelters.

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that they plus their two children either used the two-seat sports car or rented a car for all personal driving. The Tax Court stated that this "defies belief."

[46] This may be due to lack of resources, prosecution of other crimes taking a higher priority, and the desire to prosecute only cases with a high likelihood of ultimate conviction.

B. Theory of Penalties

Overview

Civil and criminal penalties are only one part of a legal system designed to encourage compliance with the tax collection process. Withholding of tax on many types of income, information reporting on many payments and expenditures, audit and collection procedures, taxpayer assistance programs, and patriotic and moral values also provide incentives for timely and accurate computation and payment of tax.

In addition to having a deterrent effect, penalties can also be viewed as providing a just punishment for socially undesirable behavior, compensation to the Government for the cost of audit and detection, and an additional source of revenue for the Government. This portion of the pamphlet discusses the ways these theories may have shaped the current penalty structure.

A variety of penalties may be imposed under the Code upon taxpayers who understate their tax liability or fail to comply with the tax laws in other respects. In addition, penalties may be imposed upon persons who may not directly owe tax but have other responsibilities under the Code, such as submission of information returns or the accurate preparation of returns. The following discussion of the rationales underlying the penalty system generally applies to both taxpayers and other persons with compliance responsibilities.

Economic Deterrence

One widely held view of the purpose of penalties is that they provide appropriate incentives for taxpayers to comply with the tax laws. In this view, taxpayers rationally weigh the economic costs and benefits of tax compliance. Although social and moral influences also underlie a taxpayer's decision to comply, it may be useful to examine penalties solely within the framework of the economic incentives they generate.

The costs of compliance, from the taxpayer's standpoint, consist of the value of the taxes and other expenses paid as well as the effort required for timely and accurate compliance with the laws. The benefits to the taxpayer from compliance stem from negative consequences avoided. The negative consequences of noncompliance arise from the possibility that the taxpayer will be audited and identified as a noncomplier, the original tax liability plus interest and penalties will have to be paid, and criminal charges may be brought.

The expected benefit to the taxpayer of noncompliance equals the value of failing to pay tax without detection, minus the chance of being caught times the perceived costs, if caught. An increase in the probability of detecting noncompliance or an increase in the level of the potential penalty imposed generally will raise the in-

centive for compliance.[47] The deterrent effect of penalties is therefore integrally related to both the likelihood of detection and the severity of the penalties.

Under the economic deterrence view, higher penalties may substitute for a higher likelihood of detection. For example, information reporting and withholding on wages make detection of tax evasion on wages relatively easy; the likelihood of detecting the overstatement of business expenses may be much lower. It may still be possible to provide equivalent incentives for taxpayer compliance if the penalty on overstatement of business expenses is correspondingly higher than that for underreporting of wage income. To maximize taxpayers' incentives to comply, the relationship of penalties and detection suggests that information reporting, audit programs, and penalty structures should be considered simultaneously.

A more complex or uncertain penalty structure may actually increase compliance relative to a structure that is simple and certain, if taxpayers are risk-averse. If a taxpayer correctly perceives the average level of penalties which may be imposed but is uncertain about the exact level of penalty which would be imposed in his or her specific case, the incentive for compliance may be greater than if the penalty level were certain. This is because the risk-averse taxpayer generally will respond more strongly, for example, to a 25-percent chance of being penalized $10,000 than a 50-percent chance of being penalized $5,000.

A more complex and uncertain penalty structure may, however, make it difficult for taxpayers to evaluate accurately the average potential penalty. If taxpayers underestimate potential penalties, increasing taxpayer awareness of the costs of noncompliance will increase the deterrent impact of the penalties. Conversely, it may be in the Government's interest for taxpayers' perceptions to overestimate the average size of penalties since this will provide a larger incentive to comply.

Complexity and uncertainty about the application of the tax laws often raise the costs of compliance since the taxpayer may be unable to determine simply and accurately the tax due. Instead, complexity may force the taxpayer to retain more sophisticated advice which still may not be determinative.[48] Many argue that fairness dictates that penalties be less harsh in these situations, but a deterrence view would not necessarily lead to the same conclusion. The incentive to comply may be the same regardless of how complex the law. As long as additional resources and effort expended by the taxpayer will generate more accurate compliance, the incentive to comply will still be effective; it does not depend on the ability of the taxpayer to obtain easily the correct outcome.

Some take the view that the penalty structure should be used to encourage taxpayers to expend a reasonable effort to comply with the tax laws. Others argue that the true function of the penalty structure is simply to advance the end result of timely payment by the taxpayer of the correct amount of tax due. However, basing

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[47] There may be situations where an increase in the penalty will have no impact because the incentive to comply is still too small or was already so large that there will be no additional impact on the incentive to comply.

[48] For example, the taxpayer may be able to request a private letter ruling from the IRS on the tax consequences of a particular transaction.

penalties on the results of the effort, i.e., the amount of tax understatement, while ignoring fault or the reasonableness of the taxpayer's position, may provide to the taxpayer the appropriate incentives to comply. It will usually be administratively easier for the Government to measure the amount of tax understatement than the efforts made by the taxpayer to comply.[49] The penalty structure in the Code embodies a mixture of both principles, since some penalty rates are based to a degree on determinations of the reasonableness of the taxpayer's position and effort applied in complying.

Social or Moral Deterrence

Another, complementary view of penalties is that they provide social or moral deterrence of inappropriate or socially undesirable behavior. The impact of tax penalties in this regard may be limited, primarily due to the fact that the imposition of penalties is not publicized, unless the penalties are contested in court.[50] The imposition of penalties may have a private moral deterrence value, which would be entirely dependent on the values of the taxpayer who is penalized.

Fairness

A different view of the purpose of penalties suggests they serve a purpose beyond promoting incentives for efficient compliance. Instead, penalties may be enacted because of fairness considerations, as just punishment for transgressions against societal standards. A view of penalties based purely on incentives suggests few reasons for limiting the size of penalties. Fairness considerations may, however, lead to limitations on the size of penalties. Few would consider it equitable to impose the same punishment on a murderer as on a tax cheat. Fairness demands the punishment fit the crime.

Most people believe that penalties should be roughly proportional to the degree of the violation. It may be difficult to follow this principle in actuality, however, because the nature of the violation varies considerably among taxpayers. The measure of the violation is usually based on the amount of tax underpaid, so that the penalty imposed is consequently proportional to the tax underpayment. If, however, the measure of the violation is the number of times an act is done or not done (such as failure to file information returns), the total penalty may well be viewed as disproportionate to the violation committed. Because of this, a cap on the amount of total penalty imposed may be viewed as equitable. In some circumstances, however, repeated violations may be viewed as justifying increased penalties.

The sheer size of a penalty may limit its effectiveness. If a penalty is viewed as too large or inappropriate for the particular violation, based on equity considerations, the IRS and the courts may hesitate to impose it. Once taxpayers recognize that the Government is unwilling to impose certain harsh penalties, a smaller,

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[49] Peculiarly, penalties based solely on effort would require the IRS to penalize taxpayers who paid approximately the correct tax but reached this result with insufficient care and diligence in order that appropriate effort incentives are provided to all taxpayers.

[50] By contrast, some other countries provide public lists of tax offenders, presumably with the intent of increasing the social stigma associated with tax violations.

more enforceable, penalty might provide a greater deterrent effect. For example, certain violations of pension rules may result in the disqualification of the whole pension plan. This penalty is considered so draconian that it is rarely, if ever, used. A penalty more fitting to the particular violation, such as an excise tax on the dollar amount of the transaction that violated the tax rules, may prove more efficacious.

Equity considerations often lead one to consider the taxpayer's intent and efforts in complying instead of focusing solely on the amount of tax underpayment. The deterrence view instead suggests that the subjective intent of the taxpayer may not be particularly relevant for determining the level of penalties. Both views are reflected in different portions of the penalty structure of the Code. The negligence and fraud penalties, for example, require that fault by the taxpayer be demonstrated, which reflects the equity view of penalties. The substantial understatement penalty, on the other hand, is based on the return position taken by the taxpayer, and may be more reflective of the deterrence view of penalties.

In general, equity considerations limit the size and pattern of available tax penalties and thus may limit their ability to provide appropriate incentives for compliance. Consequently, increased detection efforts may be necessary to provide sufficient compliance incentives. Indeed, some argue that in order for the penalty system to be viewed as equitable, Government enforcement efforts must avoid the appearance of randomness by assuring that the detection of tax law violators is relatively certain.

Penalties as Compensation for Enforcement Costs

Another view of penalties is that they serve as compensation to the Government for the cost of finding and collecting the tax from the noncomplier. This view is related to the concept of a user fee in that the taxpayer is compensating the Government for the cost of its enforcement efforts.

Under the compensation theory, penalties would not be related primarily to the taxpayer's behavior that generated the Government's assessment, but rather to the Government's costs of detecting and collecting the underassessment. This could be achieved by assessing the additional tax and interest due as well as a service charge for the amount of various types of resources which were required to locate and determine the assessment. Doing so could conflict, however, with equity goals, in that charging taxpayers for the Government's costs, which are predominantly determined by the Government and are not necessarily proportional either to the tax due or to its costs with respect to similarly-situated taxpayers, may be viewed as unfair. This view of penalties is present, however, in certain penalty provisions. For example, certain criminal penalties under the Code require a convicted taxpayer to reimburse the Government for the costs of prosecution. In addition, the penalty [51] for failure to pay taxes after notice and demand doubles [52] after the

[51] Section 6651(a)(3).
[52] Section 6651(d).

IRS notifies the taxpayer that it will levy on the taxpayer's assets.[53]

Penalties as a Revenue Source

Since most penalties assessed under the Code require the payment of additional money to the Government, penalties can be viewed as an additional revenue source beyond the regular tax imposed. The increase in the number of penalties in the last decade, combined with the continuing pressure for increased tax collections, have caused some to suggest that tax penalties are being used to collect revenue and not simply to promote compliance with the tax laws. Use of penalties in this manner may generate disrespect for the tax system and, ultimately, lead to a decline in the level of voluntary compliance.

It has been suggested by some that the changes made in 1986 to the penalty for substantial understatements of tax and the penalty for failure to deposit withholding taxes were motivated by a desire to raise additional revenue. The Omnibus Budget Reconciliation Act of 1986 increased the amount of these penalties effective for penalties assessed after the date of enactment. Because penalties generally are not assessed until a final determination of tax liability, which usually occurs after completion of the audit process, administrative appeals, and Tax Court review, the increased penalties may be imposed with respect to conduct that occurred prior to enactment. Consequently, it has been argued that the "retroactive" increase in these penalties may be unfair in that it could not deter conduct that occurred prior to the enactment of the penalty. However, some feel that the original penalty structure may have been unduly lenient and the penalties have been adjusted to punish violations more equitably.

Some may view penalties as a generally unseen tax, since penalties are not imposed upon (and are therefore not visible to) most taxpayers. On the one hand, since taxpayers who owe penalties commonly may be perceived as being guilty of misbehavior, there could be significant support for using penalties to raise additional revenue. On the other hand, some might consider the use of penalties, especially those unrelated to fault, for any purpose other than to promote compliance with the tax laws as inappropriate and unfair.

A related argument stresses the flexibility the IRS has in assessing penalties and negotiating settlements. Some argue that the IRS uses the threat of additional penalties as a tool to pressure taxpay-

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[53] This was enacted in the Tax Reform Act of 1986 in place of a user fee proposed by the Administration that would have been dependent on the effort expended by the IRS in attempting to collect the tax. The Treasury Department document entitled "Tax Reform for Fairness, Simplicity and Economic Growth" (November 1984, pp. 406-408) contained a proposal to repeal the penalty for failure to pay taxes and replace it with a cost of collection charge approximately equal to the cost of collecting the delinquent taxes. "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (May 1985) also contained this proposal (pp. 112-113). The underlying rationale was that the cost of collecting delinquent taxes would, in effect, be borne by those who have delayed making payment, rather than by all taxpayers. The proposal also was designed to encourage taxpayers to pay delinquent taxes more promptly. In lieu of adopting this proposal, the Congress maintained the general structure of the prior-law penalty for failure to pay taxes, but increased the amount of the penalty once the IRS generally initiates more expensive collection methods. Thus, the rate of the penalty doubles after the IRS notifies the taxpayer that it will levy on the taxpayer's assets.

ers into accepting unfavorable settlements. Taxpayers, though convinced that their potential litigating position is sound, may accept a settlement to avoid the possible imposition of substantial penalties. A different view of the same process may characterize the IRS as fairly applying the tax laws to collect revenue efficiently. Like many parties involved in potential judicial proceedings, the IRS may be willing to bargain away a higher level of penalties in order to most efficiently utilize its resources in the enforcement of revenue laws.

C. Tabulations of IRS Penalty Assessments [54]

The changing level of penalties in the tax collection process is illustrated by data on the number and amount of civil penalties assessed by the IRS during fiscal years 1978 through 1986. Table 1 illustrates that while the number of penalties assessed annually generally has remained stable since 1981, it has actually declined by over three million from 1984 to 1986. The total dollar amount of penalties assessed, however, has grown from approximately $1.3 billion in 1978 to nearly $7.0 billion in 1986. Similarly, the net dollar amount of penalties assessed (penalties assessed less abatements) has increased from approximately $1 billion in 1978 to $3.5 billion in 1986.

The amount of net penalties as a percent of the amount of penalties assessed has declined from nearly 75 percent in 1978 to approximately 50 percent in 1986. Although both abatements and penalties assessed have been increasing over time, it is unclear why the growth in the amount of abatements is greater than the growth in the amount of penalties assessed.

Table 1.—Number and Amount of Civil Penalties Assessed, Fiscal Years 1978–1986

Fiscal year	Number of penalties assessed (millions)	Amount of penalties assessed (billions)	Amount of net penalties [1] (billions)	Amount of net penalites as a percent of penalties assessed [1]
1978	15.4	$1.3	$1.0	74
1979	20.8	1.6	1.2	75
1980	19.6	2.1	1.6	74
1981	22.1	3.0	2.1	70
1982	26.3	5.1	3.3	65
1983	25.2	4.6	2.4	52
1984	26.1	5.1	3.1	62
1985	22.0	5.7	3.0	54
1986	22.9	6.9	3.5	51

[1] Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.

Source: Various issues of the *Annual Report of the Internal Revenue Service.*

[54] The statistical data on IRS penalty assessments contained in this section is derived from various issues of the *Internal Revenue Service Annual Report.* The IRS only began reporting penalties assessed separately from tax and penalties recommended after examination in the 1978 Annual Report. All references in this section are to fiscal years.

Table 2 provides data on the audit rate and the number of returns examined in the corresponding 1978 through 1986 period. Since 1978, the individual audit rate has declined by nearly a half and the corporate audit rate has fallen by two-thirds. The number of returns examined also has declined by over 40 percent during the same period. Despite the drop in audit rates and the number of returns examined, the number of penalties assessed has increased slightly and the dollar amount of penalties assessed has increased dramatically. This could be attributable to better targeting of enforcement resources, increased noncompliance of taxpayers, increased matching of information returns, the increase in the number of potential penalties, increased penalty rates, or a greater willingness by the IRS to impose penalties.

Table 2.—Individual and Corporate Income Tax Return Audit Rate and Returns Examined, Fiscal Years 1978–1986

Fiscal year	Individual audit rate (percent)	Corporate audit rate (percent)	Total returns examined (millions)
1978	2.16	8.01	2.4
1979	2.11	7.44	2.3
1980	2.02	6.48	2.2
1981	1.77	5.05	2.0
1982	1.55	4.73	1.8
1983	1.50	3.64	1.7
1984	1.27	2.66	1.5
1985	1.31	2.39	1.5
1986	1.10	2.25	1.3

Source: Various issues of the *Annual Report of the Internal Revenue Service.*

The data in Table 3 suggest that civil penalties also have increased in importance as an element of total revenue that is directly derived from enforcement activities. Penalties accounted for only 20 percent of the total additional tax and penalties assessed in 1978 but accounted for over 35 percent of additional tax and penalties assessed in 1986. The data in Table 3 also indicate that as a revenue source net penalties represent a very small portion, less than half of one percent, of total IRS collections. This percentage, though, is almost double that in 1978.[55]

Table 3.—Civil Penalties Assessed as a Percent of Additional Tax and Penalties Assessed and as a Percent of Total IRS Collections, Fiscal Years 1978–1986

Fiscal Year	Penalties assessed as percent of additional tax and penalties assessed	Penalties assessed as percent of total IRS collections	Net penalties[1] as percent of total IRS collections
1978	20.65	0.32	0.24
1979	21.71	0.34	0.26
1980	22.32	0.41	0.30
1981	27.98	0.49	0.34
1982	43.05	0.80	0.52
1983	33.35	0.73	0.38
1984	35.20	0.74	0.46
1985	33.09	0.76	0.41
1986	35.94	0.89	0.45

[1]Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.

Source: Various issues of the *Annual Report of the Internal Revenue Service.*

[55] The amount of penalties assessed does not represent the revenue gain to the Government because assessed penalties are often not collected. Because it is likely that the ability to collect penalties from taxpayers is considerably worse than for normal tax collections, the amount of assessed penalties actually collected as a percentage of total IRS collections is likely to be lower than Table 3 indicates. There is no available data indicating the amount of penalties assessed which are actually collected.

Table 4 contains data on the number and amounts of civil penalties assessed by type of return for 1986. Penalties assessed with respect to individual income tax returns (11.6 million penalties assessed) comprised over 50 percent of the total number of penalties assessed. Approximately 9.4 million (or 81 percent) of these penalties on individuals were estimated tax and failure to pay penalties. Nearly nine million employment tax penalties were assessed for the 1986 fiscal year, with the vast majority imposed for delinquency and failure to pay. Only 14 thousand civil fraud penalties, totaling $185 million, were assessed in 1986.

The percentage of net penalties to penalties assessed varies significantly for the various types of penalties. In general, the ratio of net penalties to penalties assessed is lower for the corporate penalties as compared to the individual penalties. Much of the observed variation among the types of penalties is due to differences in assessment procedures and statistical tabulation methods. For example, failure to file, failure to pay, and estimated tax penalties are usually assessed before the IRS appeals process, and are often asserted automatically by computer. In contrast, negligence and civil fraud penalties are usually assessed, except in cases of jeopardy, only after court proceedings or after the taxpayer has conceded that the application of the penalties is correct. Accordingly, the ratios of net penalties to penalties assessed are much higher for negligience and civil fraud than for estimated tax penalties.

There are other factors that may explain the variations in the ratios of net penalties to penalties assessed for the various types of penalties. The penalty for failure to pay and the estimated tax penalties may often be asserted when there has been a misapplication of a taxpayer's payment by the IRS. These penalties are abated when the payment is correctly applied. It is also possible that an abatement may occur in a year different from when the penalty being abated was assessed. The length of time between the assessment and abatement may differ for various types of penalties and may cause spurious differences in the ratio of net penalties to penalties assessed. For all these reasons, it may be difficult to draw conclusions from these ratios regarding the effectiveness and efficiency of IRS operations, the extent that penalties are used as a bargaining tool by the IRS, or the overall impact on taxpayers of various types of penalties.

Table 4.—Number and Amount of Civil Penalties Assessed and Net Penalties, Fiscal Year 1986

	Assessments		Amount of net penalties [1] (millions)	Amount of net penalties as a percent of penalties assessed [1]
	Number (millions)	Amount (millions)		
Individual	**11.620**	**$2,482.3**	**$1,592.4**	**64**
Delinquency [2]	1.579	552.6	406.0	74
Estimated tax [3]	2.720	985.6	391.5	40
Failure to pay [4]	6.714	365.9	310.4	85
Fraud [5]	0.012	151.3	128.1	85
Negligence [6]	0.229	245.8	199.2	81
Other	0.366	181.1	157.2	87
Corporate	**0.954**	**1,507.1**	**587.1**	**39**
Delinquency [2]	0.164	598.5	175.2	29
Estimated tax [7]	0.336	331.4	151.9	46
Failure to pay [4]	0.432	383.9	110.6	29
Fraud [5]	0.001	26.3	22.7	86
Negligence [6]	0.004	28.9	26.5	92
Other	0.017	138.1	100.2	73
Employment	**8.918**	**1,770.1**	**875.4**	**49**
Delinquency [2]	2.614	763.1	502.4	66
Failure to pay [4]	5.182	376.8	190.8	51
Fraud [5]	0.001	1.9	1.8	95
Other	1.121	628.4	180.4	29
Excise [8]	**0.921**	**249.5**	**70.6**	**29**
Estate and Gift [8]	**0.027**	**91.2**	**2.8**	**3**
All Other	**0.369**	**560.5**	**169.7**	**30**
Non-Return	**0.106**	**267.6**	**217.2**	**82**
Total, All Civil Penalties	**22.914**	**$6,928.3**	**$3,515.2**	**51**

[1] Net penalties are penalties assessed during the fiscal year less penalties abated during the fiscal year.
[2] Sec. 6651(a)(1).
[3] Sec. 6654.
[4] Sec. 6651 (a)(2) and (a)(3).
[5] Sec. 6653(b).
[6] Sec. 6653(a).
[7] Sec. 6655.
[8] Primarily sec. 6651 (a)(1), (a)(2), and (a)(3).

Source: *1986 Annual Report of the Internal Revenue Service.*

D. Overlapping Penalties

In General

The civil tax penalty provisions of present law may be criticized for providing multiple penalties that may be imposed with respect to a single act or failure to act. One basis for this criticism is that the total dollar amount of all potentially applicable penalties may bear no relation to the conduct of the person that is subject to the penalties. In fact, the imposition of multiple penalties for civil tax purposes may result in total monetary penalties that greatly exceed the monetary penalties for comparable non-tax Federal offenses. The use of statutory caps for many penalties (see part F., below) may mitigate the harshness of these effects.

An additional criticism is that the extent of the overlap among certain penalty provisions is unclear to taxpayers and the IRS. Thus, if two or more penalties are intended to apply to a single act or failure to act, the uncertainty concerning the possible application of such penalties may reduce their intended effect in deterring objectionable behavior. Furthermore, to the extent that the IRS does not uniformly apply the same penalty or penalties to identical or substantially similar conduct, the penalty provisions can be criticized as unfair. On the other hand, however, some uncertainty is unavoidable if an element of judgment is involved in the imposition of a penalty (such as, for example, where there is a reasonable cause exception to a penalty).

Overlap of Understatement Penalties and Negligence/Fraud Penalties

As previously mentioned in parts I., B. and C. (above), taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or fraud. In addition, Congress has recently enacted several penalties that apply to underpayments of tax without regard to whether the conduct of the taxpayer that led to the underpayment was negligent or fraudulent.[56] For example, the substantial understatement penalty generally applies if there is an understatement of tax for any taxable year that exceeds the greater of (1) 10 percent of the tax required to be shown on the return, or (2) $5,000 ($10,000 for most corporations). Similarly, the penalty for income tax valuation overstatements and the penalty for estate or gift tax valuation understatements generally apply to an underpayment of tax that is attributable to a valuation overstatement or valuation understatement that exceeds a specific percentage of the correct valuation.

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[56] These "no fault" penalties, however, may be waived by the IRS if the taxpayer establishes that (1) there was a reasonable basis or reasonable cause for the position claimed on the return and (2) the taxpayer acted in good faith.

Some have argued that it is inappropriate to impose the negligence or fraud penalty and an understatement penalty with respect to the same underpayment of tax because the understatement penalties were designed to apply without proving fault on the part of the taxpayer (which is a necessary element in proving negligence or fraud). On the other hand, it may be appropriate to permit the imposition of both penalties with respect to the same underpayment in appropriate circumstances, because the understatement penalties and the negligence and fraud penalties are targeted at different aspects of the taxpayer's behavior. Thus, imposing both penalties could be necessary in order to provide a sufficient deterrent to different elements of objectionable behavior by the taxpayer.

Overlap of Penalty for Aiding and Abetting Understatement of Tax Liability and Penalty for Promoting Abusive Tax Shelters

The recently enacted penalties for aiding and abetting the understatement of tax liability and for promoting abusive tax shelters also may be imposed with respect to a single act of a person. For example, an attorney who assists in the organization of a tax shelter by preparing an opinion with respect to the availability of tax benefits may be subject to the aiding and abetting penalty and the penalty for promoting abusive tax shelters if the opinion contains a false or fraudulent statement that the attorney knows will result in an understatement of tax. In addition, person's conduct with respect to a single tax shelter may lead to the imposition of multiple penalties for promoting abusive tax shelters.[57]

The imposition of multiple civil penalties with respect to a single tax shelter may lead to a total amount of penalties that greatly exceeds the gross receipts or net income earned by the person from the shelter. It could be argued, however, that this result is appropriate given the fact that the activities of the person may result in an understatement of tax by a large number of taxpayers. One way to mitigate any perceived unfairness in this provision would be to provide an overall limit on the penalty, based on either gross receipts or net income. It is also possible that the application of the passive loss limitations contained in the Tax Reform Act of 1986 may significantly curtail tax shelter activities, thereby decreasing the incidence of tax shelter penalties.

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[57] In *Waltman v. U.S.*, 618 F. Supp. 718 (M.D. Fla. 1985), the court held that the term "activity" as used in section 6700 refers to each sale of an interest in a tax shelter, and, consequently, a minimum $1,000 penalty could be imposed with respect to each sale. On the other hand, in *Spriggs v. U.S.*, 87-2 USTC Par. 9392 (E.D. Va. 1987), the court concluded that the term "activity" refers to the overall activity of promoting an abusive tax shelter, and, thus, only a single penalty may be imposed for all sales activities.

E. Gaps in Current Penalty Structure

Despite the large number of civil penalty provisions provided under present law, in a number of cases penalties are not imposed with respect to undesirable conduct either because no penalty applies to the conduct or the IRS is reluctant to assert a penalty that may be applicable to the conduct. The IRS may be reluctant to assert an otherwise applicable penalty if the amount of the penalty greatly exceeds the amount of tax that is underpaid as a result of the undesirable conduct.

For example, it is understood that the IRS ordinarily does not assert a penalty for a non-willful failure to file an information return relating to distributions from profit-sharing and retirement plans because the only penalty that applies to such conduct is a $25 penalty for each day that the return is not filed.[58] In contrast, the penalty that generally applies to a non-willful failure to file other types of information returns is $50, regardless of the length of time that the return is not filed.

As an additional example of undesirable conduct where a penalty is not asserted, it is understood that the IRS ordinarily does not assert a penalty for a non-willful failure to file an information return with respect to the payment of fixed or determinable annual or periodical income to a nonresident alien or a foreign corporation. The only applicable penalty is the penalty for failure to file a tax return, which the IRS generally considers inappropriate for a failure to file an information return.[59]

Finally, it has been suggested that the current penalty provisions do not adequately address the failure of S corporations to file timely returns. Under present law, a partnership that fails to file timely a return or files a return that fails to show required information is liable for a penalty for each month (not to exceed five months) that the partnership return is late or incomplete. The amount of the penalty for each month is $50 multiplied by the number of partners in the partnership for the taxable year for which the return is due. There is no similar penalty that applies to S corporations.[60]

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[58] Under the authority of section 6047, the IRS requires the filing of information returns on Form W-2P (statement for recipients of annuities, pensions, retired pay or IRA payments) and Form 1099-R (statement for recipients from profit-sharing, retirement plans, individual retirement arrangements, etc.). In addition, under the same authority, the IRS requires a copy of each Form W-2P and each Form 1099-R to be provided to the recipient of the annuity, pension, retired pay, IRA payment or total distribution. The only applicable penalty for the failure to file the information return or payee statement is contained in section 6652(e), which imposes a penalty of $25 for each day a return or statement required under section 6047 is not filed.

[59] Treas. reg. sec. 1.1461-2 requires withholding agents to (1) file an annual information return on Form 1042S with respect to each recipient of a payment of fixed or determinable annual or periodical income, and (2) provide a copy of the Form 1042S to the recipient of the income. This information is used by the IRS to verify that each withholding agent is deducting and withholding the correct amount of tax. In addition, the IRS compiles the information submitted on Form 1042S by country of residence of the recipient and supplies it to each country that has entered into a treaty with the United States that provides for the mutual exchange of information.

[60] The general $50 penalty for the failure to furnish payee statements applies to the failure of an S corporation to furnish a copy of information shown on the return to shareholders of the S corporation.

F. Caps on Penalties

Several of the existing civil tax penalties that relate to information reporting are capped at a specific dollar amount. For example, the total amount of penalties that may be imposed with respect to any calendar year for the failure to file certain information returns, the failure to furnish certain payee statements, or the failure to include a taxpayer identification number on certain returns or statements generally is limited to $100,000. Similarly, a $20,000 cap generally applies to penalties that may be imposed with respect to any calendar year for the failure to include correct information on certain information returns or payee statements.

The limitations on the total amount of penalties that may be imposed with respect to any calendar year do not apply in the case of returns and statements that relate to the reporting of interest, dividends, or patronage dividends. In addition, the $100,000 cap for the failure to file certain information returns and the $20,000 cap for the failure to include correct information on certain information returns or payee statements do not apply if the failure is due to intentional disregard of the filing requirement.[61]

It has been suggested that the information reporting penalties should not be limited to a specific dollar amount because a limitation diminishes the effectiveness of the penalty where there has been a failure to properly file a large number of returns or payee statements.[62] By limiting the maximum penalty that may be imposed, the cost of complying with the filing requirements for any year may exceed the amount of the penalty for that year, and, consequently, there may be no incentive to comply with the filing requirement. Because, however, the total failure to file information returns may well be regarded as intentional, resulting in the inapplicability of any cap, this problem may not arise in actuality.

In addition, the limitations may be criticized for treating more favorably those persons that are required to file a large number of returns or payee statements. For example, a business that files 10,000 information returns containing incorrect information for any taxable year would pay an average penalty of $2 per return ($20,000 cap divided by 10,000 returns), while another business that files 50 information returns containing incorrect information for any taxable year would pay the full penalty of $5 per return.[63]

In response to the argument in favor of removing the cap on penalties, it has been suggested that the caps are necessary because otherwise filers could be subject to enormous penalties that are disproportionate both to the filer's conduct and to the penalties for

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[61] In the case of intentional disregard of the filing requirement, the amount of the penalty is generally increased to $100 per return.

[62] See, for example, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985), pp. 112-113.

[63] Section 6723.

many other Federal offenses. Absent a cap on penalties, the IRS may be reluctant to assert penalties of such magnitude.

If it is determined that caps are necessary, it may be appropriate to extend the applicability of the caps to returns and statements that relate to the reporting of interest, dividends, and patronage dividends (absent willfulness in the failure to file).

G. Complexity of Penalties

The civil tax penalties of present law have been criticized as unduly complex and confusing both to taxpayers and the IRS. In the case of taxpayers, complexity may result in the penalties not providing an adequate deterrent to undesirable behavior. This may occur if the penalties are so complex that a taxpayer is unable to determine readily the application of the law to the taxpayer's particular situation. In the case of the IRS, aspects of the penalties may be so complex as to be unadministrable by the average IRS employee. Additionally, complexity may lead to uneven application of penalties to similarly situated taxpayers. Thus, a penalty may be asserted with respect to a particular taxpayer's conduct while another taxpayer, who engaged in the same or substantially similar conduct, is not penalized at all or is subject to a penalty of a lower dollar amount. This uneven application of the penalty provisions by the IRS may lead to disrespect for the tax system and a decrease in the level of voluntary compliance.

On the other hand, many of the complexities contained in the present-law penalty provisions are the result of an attempt to tailor the penalty to the conduct that is being penalized. For example, the substantial understatement penalty is often criticized as overly complex because the application of the penalty often depends upon whether "substantial authority" exists with respect to the treatment of an item or whether the facts relating to the treatment of an item are "adequately disclosed." The substantial authority and adequate disclosure standards are dependent upon the circumstances of the particular case and may be applied inconsistently by different revenue agents or appeals officers.

The substantial authority and adequate disclosure standards, however, may be considered necessary in order to achieve the purpose of the penalty, which is to reduce the number of taxpayers taking questionable positions on their returns in the hope that they would not be audited. It is unlikely that the penalty would achieve its purpose if it applied where the taxpayer had substantial authority for the treatment of an item or adequately disclosed the facts relating to the treatment of an item.

Another factor tending to increase the complexity of the penalty structure in the Code is the attempt to provide taxpayers and the IRS with as much guidance as possible on the scope and application of penalties. This reduces uncertainty and increases the liklihood of fairer administration and application of the penalties; it also tends to make the penalty structure more complex and detailed.

The number of tax penalties contained in present law has often been cited as an illustration of the complexity of the penalty provisions. The elimination or consolidation of many of the existing penalties may, however, lead to additional complexity or, more impor-

tantly, to penalties that are not adequately tailored to the conduct that is subject to penalty. The elimination or consolidation of many of the existing penalties could lead to increased uncertainty due to the loss of detail in the statute, increased discretion by the IRS in applying the penalties, and decreased uniformity in the application of penalties to taxpayers. As is often the case with tax legislation, some complexity may be necessary to achieve a degree of fairness.

APPENDIX: LIST OF TAX PENALTIES

This Appendix lists the penalties currently in the Internal Revenue Code. The table is organized by section of the Code ("Sec."). Next is the title of the section; a brief description of the penalty is included parenthetically if the title of the section is not self-explanatory. Finally, there is an indication of whether the penalty predominantly applies to individuals, to corporations, or to both. If the penalty relates to, is, or functions similarly to an excise tax, that is also indicated.

List of Tax Penalties Under the Internal Revenue Code

Code Sec.	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
72(m)(5)	Special rules applicable to employee annuities and distributions under employee plans	X			
72(o)(2)	Special rules for distributions from qualified plans to which employee made deductible contributions	X			
72(q)(1)	10-percent penalty for premature distributions from annuity contracts	X			
72(t)	10-percent additional tax on early distributions from qualified retirement plans	X			
4701	Tax on issuer of registration-required obligation not in registered form				X
4911	Tax on excess expenditures to influence legislation				X
4912	Tax on disqualifying lobbying expenditures of section 501(c)(3) organizations				X
4941	Taxes on self-dealing				X
4942	Taxes on failure to distribute income				X
4943	Taxes on excess business holdings				X
4944	Taxes on investments which jeopardize charitable purpose				X
4945	Taxes on taxable expenditures				X
4951	Taxes on self-dealing				X
4952	Taxes on taxable expenditures				X
4953	Tax on excess contributions to black lung benefit trusts				X
4955	Tax on political expenditures of sec. 501(c)(3) organizations			X	X
4971	Taxes on failure to meet minimum funding standards				X
4972	Tax on nondeductible contributions to qualified employer plans				X

4973	Tax on excess contributions to individual retirement accounts, certain 403(b) contracts, and certain individual retirement annuities		X
4974	Excise tax on certain accumulations in qualified retirement plans		X
4975	Tax on prohibited transactions (relating to pensions)		X
4976	Taxes with respect to funded welfare benefit plans		X
4977	Tax on certain fringe benefits provided by an employer		X
4978	Tax on certain dispositions by employee stock ownership plans and certain cooperatives		X
4978A	Tax on certain dispositions of employer securities to which section 2057 applies		X
4979	Tax on certain excess contributions (to a pension plan)		X
4979A	Tax on certain prohibited allocations of qualified securities		X
4980	Tax on reversion of qualified plan assets to employer		X
4980A	Tax on excess distributions from qualified retirement plans		X
4981	Excise tax on undistributed income of real estate investment trusts		X
4982	Excise tax on undistributed income of regulated investment companies		X
5601	Criminal penalties (relating to alcohol taxes)	X	X
5602	Penalty for tax fraud by distiller	X	X
5603	Penalty relating to records, returns, and reports (relating to alcohol taxes)	X	X
5604	Penalties relating to marks, brands, and containers	X	X
5605	Penalty relating to return of materials used in the manufacture of distilled spirits or from which distilled spirits may be recovered	X	X
5606	Penalty relating to containers of distilled spirits	X	X
5607	Penalty and forfeiture for unlawful use, recovery, or concealment of denatured distilled spirits, or articles	X	X

List of Tax Penalties Under the Internal Revenue Code—Continued

Code Sec.	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
5608	Penalty and forfeiture for fraudulent claims for export drawback or unlawful relanding			X	X
5609	Destruction of unregistered stills, distilling apparatus, equipment, and materials			X	X
5610	Disposal of forfeited equipment and material for distilling			X	X
5612	Forfeiture of tax paid distilled spirits remaining on bonded premises			X	X
5613	Forfeiture of distilled spirits not closed, marked, or branded as required by law			X	X
5661	Penalty and forfeiture for violation of laws and regulations relating to wine			X	X
5662	Penalty for alteration of wine labels			X	X
5671	Penalty and forfeiture for evasion of beer tax and fraudulent noncompliance with requirements			X	X
5672	Penalty for failure of brewer to comply with requirements and to keep records and file returns			X	X
5673	Forfeiture for flagrant and willful removal of beer without tax payment			X	X
5674	Penalty for unlawful production or removal of beer			X	X
5675	Penalty for intentional removal or defacement of brewer's marks and brands			X	X
5681	Penalty relating to signs (relating to liquors)			X	X
5682	Penalty for breaking locks or gaining access (relating to liquors)			X	X

5683	Penalty and forfeiture for removal of liquors under improper brands		X	X
5684	Penalties relating to the payment and collection of liquor taxes		X	X
5685	Penalty and forfeiture relating to possession of devices for emitting gas, smoke, etc., explosives and firearms, when violating liquor laws		X	X
5686	Penalty for having, possessing, or using liquor or property intended to be used in violating provisions of this chapter		X	X
5687	Penalty for offenses not specifically covered (relating to liquors)		X	X
5691	Penalties for nonpayment of special taxes relating to liquors		X	X
5761	Civil penalties (relating to cigars, cigarettes and cigarette papers and fibers)		X	X
5762	Criminal penalties (relating to cigars, cigarettes and cigarette papers, and fibers)		X	X
5763	Forfeitures (relating to cigars, cigarettes and cigarette papers, and fibers)		X	X
5871	Penalties (relating to machine guns, destructive devices, and certain other firearms)		X	X
5872	Forfeitures (relating to machine guns, destructive devices, and certain other firearms)		X	X
6038(b)	Information with respect to certain foreign corporations (penalty for failure to furnish)		X	.....
6038(c)	Penalty for reducing foreign tax credit		X	.....
6038A(d)	Information with respect to certain foreign corporations (penalty for failure to furnish)		X	.....
6038B(b)	Notice of certain transfers to foreign persons		X	.....
6039E(c)	Information concerning resident status	X	.....	.....
6332	Surrender of property subject to levy		X	.....

List of Tax Penalties Under the Internal Revenue Code—Continued

Code Sec.	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
6621(c)	(Higher rate of) interest on substantial underpayments attributable to tax-motivated transactions			X	
6651	Failure to file tax return or to pay tax			X	
6652	Failure to file certain information returns, registration statements, etc.			X	
6653	Additions to tax for negligence and fraud			X	
6654	Failure by individual to pay estimated income tax	X			
6655	Failure by corporation to pay estimated income tax		X		
6656	Failure to make deposit of taxes or overstatement of deposits			X	
6657	Bad checks			X	
6659	Addition to tax in the case of valuation overstatements for purposes of the income tax	X			
6659A	Addition to tax in case of overstatements of pension liabilities			X	
6660	Addition to tax in the case of valuation understatement for purposes of estate or gift taxes	X			
6661	Substantial understatement of liability			X	
6672	Failure to collect and pay over tax, or attempt to evade or defeat tax			X	
6673	Damages assessable for instituting proceedings before the Tax Court primarily for delay, etc.			X	
6674	Fraudulent statement or failure to furnish statement to employee			X	
6675	Excessive claims with respect to the use of certain gasoline			X	X

6676	Failure to supply identifying numbers		X	
6677	Failure to file information returns with respect to certain foreign trusts		X	
6679	Failure to file returns, etc., with respect to foreign corporations or foreign partnerships		X	
6682	False information with respect to withholding	X		
6683	Failure of foreign corporation to file return of personal holding company tax		X	
6684	Assessable penalties with respect to liability for tax under Chapter 42 (relating to private foundations)	X		
6685	Assessable penalties with respect to private foundation annual returns	X		
6686	Failure to file returns or supply information by DISC or FSC		X	
6687	Failure to supply information with respect to place of residence	X		
6688	Assessable penalties with respect to information required to be furnished under sec. 7654 (relating to coordination with income taxes of possessions)	X		
6689	Failure to file notice of redetermination of foreign tax		X	
6690	Fraudulent statement or failure to furnish statement to plan participant		X	
6692	Failure to file actuarial report		X	
6693	Failure to provide reports on individual retirement accounts or annuities overstatement of designated nondeductible contributions		X	
6694	Understatement of taxpayer's liability by income tax return preparer		X	
6695	Other assessable penalties with respect to the preparation of income tax returns for other persons		X	

List of Tax Penalties Under the Internal Revenue Code—Continued

Code Sec.	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
6697	Assessable penalties with respect to liability for tax of regulated investment entities		X		
6698	Failure to file partnership return	X			
6700	Promoting abusive tax shelters, etc			X	
6701	Penalties for aiding and abetting understatement of tax liability			X	
6702	Frivolous income tax return			X	
6704	Failure to keep records necessary to meet reporting requirements under sec. 6047(d) (relating to pensions)			X	
6705	Failure by broker to provide notice to payors			X	
6706	Original issue discount information requirements		X		
6707	Failure to furnish information regarding tax shelters			X	
6708	Failure to maintain list of investors in potentially abusive tax shelters			X	
6709	Penalties with respect to mortgage credit certificates			X	
6710	Failure to disclose that contributions are nondeductible		X		
6711	Failure by tax-exempt organization to disclose that certain information or service available from Federal government		X		
6721	Failure to file certain information returns			X	
6722	Failure to furnish certain payee statements			X	
6723	Failure to include correct information (on information returns)			X	
7201	Attempt to evade or defeat tax			X	
7202	Willful failure to collect or pay over tax			X	

7203	Willful failure to file return, supply information, or pay tax		X	
7204	Fraudulent statement or failure to make statement to employees		X	
7205	Fraudulent withholding exemption certificate or failure to supply information	X		
7206	Fraud and false statements		X	
7207	Fraudulent returns, statements, or other documents		X	
7208	Offenses relating to stamps		X	
7209	Unauthorized use or sale of stamps		X	
7210	Failure to obey summons	X		
7211	False statements to purchasers or lessees relating to tax		X	
7212	Attempts to interfere with administration of internal revenue laws	X		
7213	Unauthorized disclosure of information	X		
7214	Offenses by officers and employees of the United States	X		
7215	Offenses with respect to collected taxes		X	
7216	Disclosure or use of information by preparers of returns	X		
7231	Failure to obtain license for collection of foreign items		X	
7232	Failure to register or false statement by manufacturer or producer of gasoline or lubricating oil		X	X
7240	Officials investing or speculating in sugar		X	X
7241	Willful failure to furnish certain information regarding windfall profit tax on domestic crude oil		X	X
7261	Representation that retailers' excise tax is excluded from price of article		X	X
7262	Violation of occupational tax laws relating to wagering—failure to pay special tax		X	X
7268	Possession with intent to sell in fraud of law or to evade tax		X	X
7269	Failure to produce records		X	
7270	Insurance policies (relating to intents to evade the excise tax on foreign insurers)			X
7271	Penalties for offenses relating to stamps		X	

List of Tax Penalties Under the Internal Revenue Code—Continued

Code Sec.	Title (Description)	Penalty predominantly applicable to—			
		Individuals	Corporations	Both	Excise
7272	Penalty for failure to register (relating to alcohol and tobacco taxes)			X	
7273	Penalties for offenses relating to (occupational stamp) taxes			X	
7275	Penalty for offenses relating to certain airline tickets and advertising			X	
7304	Penalty for fraudulently claiming drawback			X	X
7341	Penalty for sales to evade tax			X	
7342	Penalty for refusal to permit entry or examination			X	

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